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# REPOSSESSIONS OF REAL PROPERTY— A NEW TAX TREATMENT

Jerry A. Kasner*

The far-reaching effects of the 1964 Revenue Act have occupied the attention of tax commentators and practitioners for the last several months. As a result, important revenue measures adopted subsequent to the more comprehensive revisions may be overlooked. A case in point is Public Law 88-570, enacted effective September 2, 1964, now Section 1038 of the Internal Revenue Code. Because this new section radically changes the tax consequences of repossession or reacquisition of real property in the event of default by the purchaser, it deserves careful analysis and consideration.

Since this new law is only a few months old, no regulations have been proposed or issued. However, in addition to the Senate Committee Reports on Public Law 88-570, pre-existing regulations and decisions are extremely helpful in assessing the application and effect of the changes.

## Analysis of Section 1038

According to Section 1038(a), the new section will encompass the determination of gain or loss resulting from any reacquisition of real property by a seller in partial or full satisfaction of an indebtedness which arose from the sale and which was secured by the property sold. The broad application of the section is affirmed by the Senate Committee Reports, which indicate that it applies whether the seller sustained a gain or loss on the sale, used the installment method to report a gain or some other method to report that gain or loss, or retained title to the property.[1] All that is required is that the seller retain some form of security for the purchaser's indebtedness, that the purchaser's default be actual or imminent, and that the seller reacquire the property in partial or full satisfaction of the purchaser's indebtedness.[2]

Section 1038(b) sets forth the method of determining the gain resulting from such reacquisition. Basically, the gain is equal to the

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1 Senate Committee Reports on Public Law 88-570, Section (a), 645 CCH Standard Federal Tax Reports, § 4645G.05.

2 *Ibid.*

amount of money or value of property actually received by the seller, less the total gain on the sale previously reported as income by the seller. Payments received by the seller do not include the purchaser's obligations, but do include any payments by the purchaser for the benefit of the seller, and any payments made by the purchaser at the time of the reacquisition.[3] The taxable gain is further limited, however, to the difference between the original selling price and the seller's adjusted basis for the property, less any amounts the seller had already reported as income, and less any amounts the seller must pay to complete the reacquisition. The difference between the selling price and the seller's adjusted basis will be determined as of the time of sale, and the gross selling price will be reduced by the expenses of sale related thereto.[4] The Committee Reports are careful to point out that the gain resulting from reacquisition "does not change the type of income which results."[5] This raises a clear implication that the gain on repossession is taxable in the same manner as the gain on the original sale. The Committee Reports use a real estate dealer as an example, and indicate his gain on repossession would be ordinary income. Section 1038 (b)(3) and the Committee Reports state that gain computed under this section shall be recognized regardless of any other provision of the Internal Revenue Code relating to income tax.[6] In view of this broad statement and the clear application of the section to all reacquisitions of real property by virtue of Section 1038(a), it is reasonable to conclude that the new section, where applicable, supercedes prior law, regulations and decisions in this area.

A taxpayer may realize additional gain in connection with reacquisition of real property if prior thereto, he treated any portion of the purchaser's obligation as worthless. Under Section 1038(d), he will be deemed to have recovered an amount equal to the amount he treated as being worthless, and this amount shall also be restored to his basis for the purchaser's obligation.

Section 1038(c) provides that the reacquired property will take a basis in the hands of the seller equal to the seller's adjusted basis for the purchaser's indebtedness, increased by the amount of the gain on reacquisition recognized under Section 1038(b), and increased by any amounts the seller had to pay in connection with the reacquisition. The purchaser's obligation then takes a basis of zero in the hands of the seller, whether or not it is fully discharged by the reacquisition.[7]

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[3] *Id.*, Section (b).
[4] *Ibid.*
[5] *Ibid.*
[6] *Ibid.*
[7] *Id.*, Section (c).

Section 1038(e) extends the new rules to sales of residences where the seller has elected the benefits of Sections 121 or 1034, pertaining to nonrecognition, under certain circumstances, of gain or loss on sales of residences. Basically, if the reacquired property is sold within one year of the date of reacquisition, no gain is recognized on the reacquisition, and the resale relates back to the original sale. The benefits of Section 121 extend to taxpayers over 65 years of age, and the benefits of Section 1034 extend to taxpayers who build or otherwise replace their residence within the period prescribed by the statute.

According to Section 1038(f), the section will not apply to reacquisition of real property by organizations described in Section 593(a). These are mutual savings banks, domestic building and loan associations, and cooperative banks.

Section 1038 applies to all reacquisitions after September 2, 1964. In addition, taxpayers have one year from that date to elect application of the provisions to any reacquisitions after December 31, 1957, providing the transaction is not barred by the statute of limitations.[8]

## Background—Methods of Reporting Sales of Real Property

As noted, Section 1038 applies to all sales of real property regardless of the extent of the gain or loss, or the method used to report the sale for tax purposes. To understand the impact of the new provisions, it is first necessary to review the tax consequences of such sales.

Taxable gain or loss is recognized on any sale or other disposition of real property.[9] The amount of gain or loss is determined by the difference between the amount realized from the sale or disposition and the adjusted basis of the property in the hands of the seller.[10] "Amount realized" as used in this context includes the amount of money and the fair market value of property received by the seller.[11] Section 1001 makes no distinction between cash and accrual basis taxpayers. If the purchaser's obligations are considered "property" within this definition, there would be no difference between cash and accrual basis taxpayers, since both would "realize" the entire sales price in cash and "property" at the time of sale.[12]

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8 P.L. 88-570, Sections 2(a), 2(c), 645 CCH Standard Federal Tax Reports, § 4645G.05.

9 Int. Rev. Code of 1954, § 1001.

10 *Ibid.*

11 *Ibid.*

12 Treas. Reg. § 1.453-6(a)(1).

If the purchaser's obligations are not treated as property, this approach fails.

The Courts have consistently held that the purchaser's obligations do not constitute "property received" by a cash basis taxpayer unless equivalent to cash.[13] Thus negotiable promissory notes secured by the property sold would generally have an ascertainable market value, be readily convertible into cash; and would, therefore, be treated as property received by a cash basis seller. Similarly, contract rights for which there is a market have been held equivalent to cash.[14] On the other hand, the following have been held not to be equivalent to cash: non-negotiable unsecured notes,[15] unsecured contractual promises,[16] and land sale contracts where the seller reserves title until the purchaser has fully performed.[17] While the Internal Revenue Service concedes not all obligations of a purchaser constitute property to the seller, it will make this concession only in "rare and extraordinary cases."[18] For example, in states where land sale contracts are freely assignable, the Commissioner contends the purchaser's contract obligation is property received by the seller.[19]

The foregoing gives rise to two possibilities: the purchaser's obligations are property, in which case the seller realizes the entire selling price, and the transaction is closed, or the obligations are not property, in which case the sale will not be consummated for tax purposes until the seller has received all of the money and property due or collectible. The tax consequences in each situation are outlined in the following regulations:

> (a) *Value of Obligations.* (1) In . . . sales of real property involving deferred payments in which the payments received during the year of sale exceed 30 percent of the selling price, the obligations of the purchaser received by the vendor are to be considered an amount realized to the extent of their fair market value in ascertaining the profit or loss from the transaction. . . .
>
> (2) If the obligations received by the vendor have no fair market value, the payments in cash or other property having a fair market

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[13] Howard W. Johnson, 14 T.C. 560 (1950); A. B. Culbertson, 14 T.C. 1421 (1950); Nina J. Ennis, 17 T.C. 465 (1951); Estate of Clarence J. Ennis, 23 T.C. 799 (1955); Curtis R. Andrews, 23 T.C. 1026 (1955).

[14] Frank Cowder, Sr., 32 T.C. 853 (1959).

[15] Mainard F. Crosby, 14 B.T.A. 980 (1929); Hudson Engineering Corp., 11 T.C. 1042 (1948); Abraham Kaufman, 14 T.C.M. 846 (1955).

[16] Howard W. Johnson, 14 T.C. 560 (1950); Curtis R. Andrews, 23 T.C. 1026 (1955).

[17] Nina J. Ennis, 17 T.C. 465 (1951); Hurlburt, 25 T.C. 1286 (1956).

[18] Treas. Reg. §§ 1.1001-1(a), 1.453-6(a)(2); Rev. Rul. 402, 1958-2 Cum. Bull. 15.

[19] Estate of Clarence W. Ennis, 23 T.C. 799 (1955).

> value shall be applied against and reduce the basis of the property sold, and, if in excess of such basis, shall be taxable to the extent of the excess. Gain or loss is realized when the obligations are disposed of or satisfied, the amount thereof being the difference between the reduced basis as provided in the preceding sentence and the amount realized therefor. . . .[20]

In the first situation, the entire gain or loss is realized and reported in the year of sale, while in the second, the seller is first entitled to collect an amount equal to his basis for the property sold, then report additional amounts collected as income when, as and if collected, or realized by disposition of the purchaser's obligations. This second method is commonly referred to as the "cost recovery"[21] method of reporting.

The regulations also do not distinguish between cash and accrual basis taxpayers, and it is generally held that an accrual basis taxpayer may use the cost recovery method if the purchaser's obligations do not have a fair market value.[22] In theory, there is nothing to accrue. It is argued that there is a difference, in that a cash basis taxpayer does not have to treat the purchaser's obligations as property received unless equivalent to cash, while an accrual basis taxpayer must treat such obligations as properly accruable if they have an ascertainable fair market value.[23] This may be a distinction without a difference. Any obligation which is "equivalent to cash" must have a fair market value equal at least to that equivalent. On the other hand, "fair market value" is defined for tax purposes as the price which property will bring when offered for sale by a willing seller to a willing buyer, neither being obligated to buy or sell.[24] If the purchaser's obligation does have a fair market value, then it may be argued that it must also have a cash equivalent, i.e., the price a willing buyer would pay a willing seller. There may be instances in which property will have a fair market value but not be equivalent to cash.[25] However, in most instances, property with a fair market value has a cash equivalent, and visa versa, and the tax consequences to cash and accrual basis taxpayers will generally be the same.[26]

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20 Treas. Reg. § 1.453-6.

21 This is sometimes referred to as the "deferred payment" method.

22 C. W. Titus, 33 B.T.A. 930 (1936); Calvin T. Graves, 17 B.T.A. 1318 (1929).

23 645 CCH Standard Federal Tax Reports, § 48,010; Ritchie, Tax Problems of Builders and Investors in Acquiring Evidences of Indebtedness, 1961 So. Calif. Tax Inst. 659, 666. See also, Howard W. Johnson, 14 T.C. 560 (1950).

24 Marshman, 279 F.2d 27, 32 (6th Cir. 1960), *cert. denied*, 364 U.S. 918; S.M. 1428, IV-I Cum. Bull. 101 (1925).

25 See George L. Castner Co., 30 T.C. 1061 (1958).

26 Comm. v. Bruun, 309 U.S. 461 (1940); MERTENS LAW OF FEDERAL INCOME GIFT AND ESTATE TAXATION, Vol. 2, Chapter 11.

The other method of reporting a gain on sale of real property is the installment method authorized by Section 453, available to both cash and accrual basis taxpayers on any sale of real property. It does not apply to loss situations. To qualify, the total payments in cash and property (*not* including the purchaser's obligations) received by the seller in the year of the sale may not exceed 30% of the "selling price," which is the gross selling price including any mortgage or lien against the property sold. The taxable gain on the sale, referred to in Section 453 as the "gross profit," is the difference between the selling price and the seller's adjusted basis for the property.

To determine exactly how the gain is reported, it is necessary to determine the "total contract price," which is generally the total of cash, notes, and other property to be received by the seller. The percentage of gross profit to total contract price will determine the percentage of each installment payment included in the seller's income. In most instances, the total contract price will be the same as the selling price, unless there are liens and encumbrances against the property.

In summary, sales of real property on a deferred payment basis at a gain may be reported for tax purposes as follows:

(1) *Gain realized and reported entirely in the year of sale.* This method will apply when the installment method is not available or not elected, and the purchaser's obligations are treated as having a fair market value (or cash equivalent) in the year of sale.

(2) *No gain realized or reported until the seller has first received payment equal to his adjusted basis for the property sold.* This "cost recovery" method is also an alternative to the installment method, and may be utilized when the purchaser's obligations do not have a fair market value (or are not equivalent to cash).

(3) *Gain realized in the year of sale, but reported and taxed on the installment method.* Available when 30% or less of the total selling price is received in the year of sale, and the seller elects this method. A percentage of each installment received is treated as income.

## Comparison to Prior Law

Each of the three types of deferred payment sales of real property described herein could give rise to a reacquisition of the property sold, as each involves a continuing obligation of the purchaser to make payments. For tax purposes, the term "repossession"

appears to be used generally to refer to situations where a seller reacquires property upon the default of the purchaser.[27] The following is a comparison of the tax consequences of such repossessions of property under the new law with the results under the prior law. For the purposes of clarification and illustration, the following example will be used in making comparisons:

> Unimproved real property is sold for $100,000. It is free of encumbrances, and its adjusted basis in the hands of the seller is $60,000. The seller collects a total of $60,000 in payments on the purchase price, at which point the purchaser defaults, and the seller reacquires the property. At the time of repossession by the seller, the property has a fair market value of $150,000, still unimproved.

(1) *Gain realized and reported entirely in the year of sale.* Under the Regulations adopted in 1958, the tax effects of repossessions in this situation will depend upon whether or not the seller retained title to the property. If the seller had retained title, the gain or loss on repossession was equal to the total payments on the selling price received, plus the value of fixed improvements to the property made by the purchaser, less amounts previously reported by the seller as income on the sale, and less an amount equal to reasonable depreciation or depletion of the property while in the hands of the purchaser.[28]

If the seller had not retained the title, but reacquired it in partial or full satisfaction of the purchaser's obligation, the same Regulations provide that a gain or loss is realized on repossession equal to the fair market value of the property on date of repossession less the basis of the purchaser's obligation satisfied.[29] In this instance, the Commissioner takes the position that repossession is nothing more than a collection on an obligation, having nothing to do with the original sale, and if the value of the property exceeds the basis of that obligation, the difference is ordinary income.[30] Conversely, if the value of the property reacquired is less than the seller's remaining basis in the purchaser's obligation, the difference is deductible as a bad debt.[31]

Applying these rules to the example, it must first be assumed that the purchaser's obligation to pay the selling price had a fair market and cash equivalent value of $100,000, in which case that amount, less the seller's adjusted basis of $60,000, or $40,000, would be taxable income in the year of sale. If the seller had retained

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27 Treas. Reg. §§ 1.453-5(b), 1.453-6(c).
28 Treas. Reg. § 1.453-6(b).
29 Treas. Reg. § 1.453-6(c).
30 Treas. Reg. § 1.453-6(c); G.C.M. 880, VI-I Cum. Bull. 45 (1927).
31 *Ibid.*

title to the property, the gain on repossession under the prior law would be $20,000, determined as follows:

| | | | | |
|---|---|---|---|---|
| Total payments on purchaser's obligations ($60,000) | — | Profit or gain reported by seller ($40,000) | = | Gain on repossession ($20,000) |

If the seller had not retained title, but reacquired it in complete discharge of the purchaser's obligations to him, the gain on repossession under prior law would have been $110,000, apparently all ordinary income, as follows:

| | | | | |
|---|---|---|---|---|
| Fair market value of the property on date of repossession ($150,000) | — | Basis of purchaser's obligation ($40,000) | = | Gain on repossession ($110,000) |

In this case, since the entire gain on the sale had been reported by the seller, his basis for the purchaser's obligation would have been equivalent to the balance due, $40,000.

Under Section 1038, it makes no difference whether or not the seller retained title to the property, or how he reacquired it, or whether or not he reacquired it in complete or partial discharge of the purchaser's obligations. The gain on repossession is determined as follows:

| | | | | |
|---|---|---|---|---|
| Total payments received by seller ($60,000) | — | Gain already reported by seller ($40,000) | = | Gain on repossession ($20,000) |

*Limited,* however, as follows:

| | | | | |
|---|---|---|---|---|
| Selling price less adjusted basis of the property ($40,000) | — | Gain already reported by the seller ($40,000) | = | Gain on repossession (—0—) |

Therefore under Section 1038 there is no recognized gain on repossession, because the seller had already reported the entire gain on the transaction at the time of the sale.

(2) *Gain is not realized and taxed until the seller has first recovered his adjusted basis for the property sold.* The regulations applicable when the entire gain is taxable in the year of sale also apply to the determination of gain or loss on repossession when the seller is reporting on the "cost recovery" basis. As a result, under

prior law, tax consequences would depend on whether or not the seller retained title to the property.[32]

Referring to the example, and assuming the purchaser's obligation to pay $100,000 had no ascertainable market value or cash equivalent, the seller would apply the payments of $60,000 received to his adjusted basis for the property, also $60,000, thereby having realized no gain or loss on the sale to the date of default and repossession. Assuming the seller retained title to the property, a gain on repossession of $60,000 would have been realized:

| | | | | |
|---|---|---|---|---|
| Total payments on purchaser's obligations ($60,000) | — | Profit or gain reported by seller (—0—) | = | Gain on repossession ($60,000) |

Or, if the seller had not retained title:

| | | | | |
|---|---|---|---|---|
| Fair market value of the property on date of repossession ($150,000) | — | Basis of purchaser's obligation (—0—) | = | Gain on repossession ($150,000) |

In this situation, the purchaser's obligation, having been treated as having no fair market value, and being equal to the unreported gain on the original sale, would have a zero basis to the seller. According to the regulations, the $150,000 gain is ordinary income.

Under Section 1038, and regardless of who has title, the computation would be:

| | | | | |
|---|---|---|---|---|
| Total payments received by seller ($60,000) | — | Gain reported by seller (—0—) | = | Gain on repossession ($60,000) |

*Limited,* however, to:

| | | | | |
|---|---|---|---|---|
| Selling price less adjusted basis of property ($40,000) | — | Gain already reported by seller (—0—) | = | Gain on repossession ($40,000) |

In this situation, the effect of the new law is to tax the entire unrealized and unreported gain on the original sale to the seller at the time of the repossession. This is certainly reasonable, as he is left with the property plus $60,000 in cash.

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[32] Treas. Reg. § 1.453-6.

(3) *Gain realized in the year of sale, but reported and taxed on the installment method.* Prior to the enactment of Section 1038, gain or loss on repossession of property sold on the installment basis, regardless of who held title, was prescribed by the regulations to be equal to the difference between the fair market value of the property on date of repossession and the remaining basis to the seller of the purchaser's obligation.[33] Under Section 453(b)(2), the basis of an installment obligation is its face value less the income that would have been reported if the remainder of the obligation had been paid in full.[34]

Referring to the example, the selling price and the contract price would be the same amount, $100,000, and by subtracting the seller's basis of $60,000, the gross profit is determined to be $40,000. Assuming the sale qualified for the installment method and the seller elected to use it, he would have a profit percentage of 40%. Forty per cent of the total payments received, $60,000, or $24,000, would have been reported as gain on sale to the date of default and repossession. On that date, the remaining balance due of $40,000 on the purchaser's obligation would include $16,000 in unreported income. Prior to Section 1038, gain on repossession would have been:

| | | | | |
|---|---|---|---|---|
| Fair market value of property on date of repossession ($150,000) | — | Basis of the installment obligation ($24,000) | = | Gain on repossession ($126,000) |

The basis of the obligation was the balance due, $40,000, less the amount of unreported income, $16,000.

Gain computed under Section 1038 would be:

| | | | | |
|---|---|---|---|---|
| Total payments received by seller ($60,000) | — | Gain reported by seller ($24,000) | = | Gain on repossession ($36,000) |

*Limited* to:

| | | | | |
|---|---|---|---|---|
| Selling price less adjusted basis of property ($40,000) | — | Gain reported by seller ($24,000) | = | Gain on repossession ($16,000) |

The foregoing comparisons and examples indicate the beneficial results which may be obtained under the new section. The previous position of the Commissioner on repossessions could produce gross-

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[33] Treas. Reg. § 1.453-5(b).
[34] Treas. Reg. § 1.453-9(b)(2).

ly unfair and unrealistic tax consequences. Undue emphasis had been placed upon retention of title by the seller, which is an element of security only. In comparing the examples, it will be noticed that retention of title made as much as $90,000 difference in computing gain on repossession, all other facts being identical. The Commissioner would contend such gains are ordinary income, and there is case authority for this proposition.[35] There is also an argument that such gain should "relate back" and be treated the same as the gain on the original sale.[36] As indicated, the Senate Committee Reports also imply that gain on repossession shall be treated the same as the gain on the original sale. This should end the Commissioner's repeated attempts to treat gain on all repossessions as ordinary income, regardless of the nature of the original transaction.

Section 1038 sets forth a simple, direct and fair method of taxing gains on repossessions of real property. The net effect of Section 1038(b) is to tax the seller on the total payments on purchase price received, or the total gain on the original sale, whichever is smaller. The value of the property at the time of repossession is not a factor.

### Basis of Property Reacquired

As indicated, the property reacquired takes a basis equal to the basis of the indebtedness securing the property, plus the recognized gain on repossession, and plus any amounts the seller is forced to expend in connection with the repossession. This is also a complete change from the prior law. In sales reported on the installment method, or those not on the installment method where the seller had not retained title to the property, basis on repossession under prior law was fair market value.[37] In sales not on the installment method where the seller retained title, the basis of property repossessed was its adjusted basis at the time of sale, plus improvements made by the purchaser, less a reasonable allowance for depreciation or depletion while in the hands of the purchaser.[38]

As previously noted, the entire matter of repossessions and their treatment for tax purposes has been based upon one of two theories: (1) that the repossession relates back to and should be considered an extension of the original sale, and (2) that the re-

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35 Bowles Lunch, Inc. v. U.S. (Ct. Clms., 1940), 33 F. Supp. 235; National Life Insurance Co. v. U.S. (Ct. Clms., 1933) 4 F. Supp. 1000; P. F. Myers, 18 T.C.M. 1116 (1959), *aff'd* 287 F.2d 400 (6th Cir. 1961), *cert. denied*, 368 U.S. 828; Boatman, 32 T.C. 1188 (1959).

36 Arrowsmith v. Comm., 344 U.S. 6 (1952).

37 Treas. Reg. §§ 1.453-5(b), 1.453-6(c).

38 Treas. Reg. § 1.453-6(b).

possession is nothing more than a collection of an obligation by means of proceeding against the security. Since Section 1038 adopts the former approach as to gain, "relation back" of basis to the time of the original sale is consistent.

The determination of the basis of the indebtedness "securing" the property might pose some problems. In discussing what constitutes such indebtedness, the Committee Reports state: "An indebtedness is secured by real property . . . for example, whenever the seller had the right to take title or possession or both in the event that the purchaser defaults in his obligations under the contract."[39] It is assumed the definition of "security" will extend to the more traditional forms, where the seller does not necessarily reserve title or possession, or the right thereto, such as mortgages, deeds of trust, pledges, or other forms of liens. The Committee Reports also indicate Section 1038 will apply if the seller has recourse only to the property in the event of the purchaser's default.[40] This eliminates any possible effect of anti-deficiency laws.

The basis of the purchaser's obligation in the hands of the seller should, according to the existing rule, be equal to the balance due thereon less any portion of the balance which represents unreported income.[41] If the seller had reported the entire gain on the transaction in the year of sale, the basis of the purchaser's obligation would be the balance due thereon. However, if all or part of the gain had not been reported, due to the use of cost recovery or the installment method, the unreported gain is definitely part of the purchaser's remaining obligation, and would logically not be part of the basis of the obligation to the seller.

The rule of Section 1038(d) requiring the seller to increase the basis of the purchaser's obligation by any portion thereof previously treated as worthless will have the effect of also increasing the basis of the reacquired property to the seller.

### Nonrecognition of Losses on Repossession

The language of Section 1038 completely eliminates losses on repossession of real property. Section 1038(a) states that no gain or *loss* shall be recognized except as indicated in Section 1038(b) and 1038(d). The latter refer only to *gains* on reacquisition of the property or income resulting from having treated the purchaser's obligation as wholly or partially worthless. Thus there is no provision for recognition of losses.

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39 Senate Committee Report on Public Law 88-570, *op. cit. supra* at note 1.
40 *Ibid.*
41 Int. Rev. Code of 1954, § 453(d)(2).

It is of course possible to realize an economic loss upon repossession of property. The fair market value of the property might be less than the seller's basis for the purchaser's obligation. Although this would result in an economic loss, it is possible that a taxable gain would arise under Section 1038(b). The reason is that the fair market value is not taken into consideration for any purpose under Section 1038. This produces the benefit of nonrecognition of gain due to increase in the value of the property, and the detriment of nonrecognition of losses due to decrease in the value of the property. Under prior law, the Regulations provided for recognition of gain or loss in all situations.[42]

If there is an economic loss on repossession, it will be reflected indirectly by the fact the adjusted basis of the reacquired property will be in excess of its fair market value on date of repossession. This loss could of course be realized by selling the property, or possibly through higher depreciation deductions.

## MISCELLANEOUS CONSIDERATIONS

### *Foreclosure and Trustee's Sales*

Will Section 1038 apply if the seller "reacquires" the property by bidding for it at a foreclosure sale or sale under a deed of trust? Pre-existing Regulations refer to repurchase or reacquisition at a foreclosure sale in the context of computing gain or loss on repossession.[43] On the other hand, the Regulations under Section 166, relating to bad debts, provide that if mortgaged or pledged property is lawfully sold, and the creditor buys in the property, the creditor will realize gain or loss equal to the difference between the fair market value of the property and the basis of the debtor's obligation in the hands of the creditor.[44] While this is consistent with the prior regulations on repossessions, it is certainly not consistent with Section 1038.

The Committee Reports do not specifically refer to foreclosure, but do contain the following statement: "However, section 1038 generally would be applicable if the seller reacquires the property when the purchaser has defaulted on his obligation, or his default is imminent, even if the seller pays additional consideration."[45] This is certainly broad enough to cover purchase at a foreclosure or trustee's sale, particularly in view of the reference to payment

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42 Treas. Reg. §§ 1.453-5(b), 1.453-6(c).
43 *Ibid.*
44 Treas. Reg. §§ 1.166-6(a), 1.166-6(b).
45 Senate Committee Reports on Public Law 88-570, *op. cit. supra* at note 1.

of additional consideration, which might be the case if the seller were forced to bid on the property. Also, Section 1038(b)(3) clearly states that the rules of the section will be exclusive as to any reacquisition of property by a seller in partial or full satisfaction of a purchaser's indebtedness. In view of this, it seems indisputable that Section 1038 applies to reacquisitions at foreclosure and trustee's sales, and that the regulations under Section 166 will apply to creditors *other than* sellers enforcing purchase money obligations.

*Subsequent Collections on Purchaser's Obligations*

After the reacquired property takes the basis of the purchaser's obligation, the basis of that obligation to the seller is reduced to zero. The Committee Reports indicate this will apply to the original obligation, a substituted obligation, a deficiency judgment against the purchaser, and "any other obligations arising from the transaction."[46] The Commissioner will probably contend that subsequent recoveries on the obligation would be bad debt recoveries taxable as ordinary income, not amounts received in connection with the sale or exchange. The taxpayer might counter on the basis of *F. D. Arrowsmith*,[47] contending that the subsequent recovery is part of the gain on the original sale; therefore a capital gain if the original sale produced a capital gain.

A similar and related problem is the treatment of the amount the seller is required to include in income pursuant to Section 1038(d), because he had previously treated the purchaser's obligation as totally or partially worthless. In this situation, the matter should be easier to resolve. The intent behind this provision would seem to be to require the taxpayer to restore to income amounts claimed as bad debt deductions under Section 166 or worthless securities under Section 165(g). If the amount to be restored was deducted as a bad debt under Section 166, the mitigating effects of Section 111 would apply, and the amount the taxpayer would be required to include in income would depend on the tax benefit he received from the bad debt deduction.[48] If the obligation had been treated as a worthless security under Section 165(g), existing regulations would indicate capital gain and loss provisions of Sections 1201 through 1241 should apply.[49]

Still other related problems will be presented if at the time of the sale the seller treated the purchaser's obligation as having a

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[46] *Ibid.*
[47] 344 U.S. 6 (1952).
[48] Int. Rev. Code of 1954, § 111; Treas. Reg. § 1.111-1.
[49] Treas. Reg. § 1.453-6(c).

fair market value less than its face value. It may be argued that the difference between the face value and fair market value assigned to the purchaser's obligation should be considered "partial worthlessness" under Section 1038(d), which would then have to be restored to the obligation and reported as income at the time of repossession. However, the terms "worthless" and "partially worthless" are words of art under the Internal Revenue Code, giving rise to certain tax consequences, including bad debt and loss deductions. Valuation of an obligation at less than face value does not mean it has been treated as partially worthless.

If a seller values the purchaser's obligation at less than face value, the fair market value so determined becomes the basis of the obligation to the seller. Case decision indicates that a portion of each payment received represents a collection in excess of the basis of the obligation and is therefore ordinary income to the recipient.[50] For example, if at the time of sale the seller evaluated the purchaser's obligation at 50% of face value, each payment by the purchaser contains 50% payment on the note and 50% income on collection in excess of the basis of the note to the seller. It is possible to argue that the gain on repossession computed under Section 1038(b) would have to be allocated on the same basis, part as payment in connection with the sale, and part as a receipt in excess of the purchaser's obligation. As a result, part of the gain on repossession would be ordinary income, even though the sale produced a capital gain.

*Holding Period*

The new law makes no reference as to what date the seller shall be deemed to have acquired the property to determine his holding period in case of a subsequent sale. This was not clear under prior law, although it was suggested that where the basis of the real property to the seller was fair market value on date of repossession, that date would also commence his holding period.[51] Since Section 1038 relates repossession back to the original sale, it may be argued that the date of commencing the holding period would be the date of sale. In the absence of statutory authority, and in view of intermediate ownership of the property by the purchaser, this assumption has little foundation, and it is safer to assume the seller's holding period for the reacquired property will begin with the date of reacquisition.

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[50] Shapfa Realty Corporation, 8 B.T.A. 283 (1927); Victor B. Gilbert, 6 T.C. 10 (1946); A. B. Culbertson, 14 T.C. 1421 (1950).

[51] 643 CCH Standard Federal Tax Reports, § 2874.02.

## Conclusion

In an economy of rising real estate values, the new provisions of Section 1038 will mitigate the often harsh, unfair, and unrealistic results heretofore advocated by the Internal Revenue Service. Of course, if real estate values were declining, the new provisions would produce an adverse effect on taxpayers who could not claim losses on repossessions. This is a small price to pay for the consistency and reasonableness of the new law. Let us hope the Commissioner, in determining the position he will take in interpreting and enforcing these new provisions, will also be guided by principles of consistency and reasonableness.